General Services Administration
Office of General Counsel
Washington, DC 20405

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May 9, 1994

Mr. William F. Caton
Acting Secretary
Federal Communications Commission
1919 M Street, NW, Room 222
Washington, DC 20554

Subject: Price Cap Performance Review for Local Exchange Carriers, CC Docket No. 94-1

Dear Mr. Caton:

Enclosed please find the original and nine copies of the Comments of the General Services Administration in the above referenced proceeding.

Sincerely,

Tenley A. Carp
Assistant General Counsel
Personal Property Division

Enclosures

cc: International Transcription Service
Industry Analysis Division

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BEFORE THE
FEDERAL COMMUNICATIONS COMMISSION
WASHINGTON, D.C. 20554

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In the Matter of Price Cap Performance Review for Local Exchange Carriers	CC Docket No. 94-1

COMMENTS OF THE GENERAL SERVICES ADMINISTRATION

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May 9, 1994

COMMENTS OF THE GENERAL SERVICES ADMINISTRATION

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COMMENTS OF THE GENERAL SERVICES ADMINISTRATION

SUMMARY

As the agency vested with the responsibility for acquiring telecommunications services for use of the Federal Executive Agencies, GSA supports the goals and framework of the LEC price cap plan. GSA urges the Commission to reaffirm that the primary goal of the plan is just and reasonable rates for innovative, high quality services. GSA believes, however, that certain revisions to the plan are absolutely necessary to ensure that ratepayers, as well as LECs, benefit from this alternative to traditional rate of return regulation.

First of all, LEC price cap indices should be reduced to reflect the fall in the cost of capital since the plan was adopted. The sharing and low-end adjustment mechanisms should also be realigned with capital costs. To this end, the Commission should immediately commence a proceeding designed to determine a new rate of return to be effective on January 1, 1995. The Commission should then adopt a trigger mechanism which is sensitive to changes in the capital markets to ensure that the underlying level of access rates remains just and reasonable.

Secondly, the Commission should increase the productivity factors employed in the plan from 3.3 and 4.3 percent to 4.1 and 5.1 percent. This change will ensure that ratepayers share in the benefits of increased LEC productivity on an equitable basis.

Finally, the Commission should use the information generated by this proceeding to establish a formal reporting program which

will allow it to measure the growth of competition for local exchange and interstate access over time. Such a program will not only provide the basis for prudent revision of the LEC price cap plan, it will also provide a reliable information resource for all those engaged in the national debate over the future of telecommunications in America.

BEFORE THE
FEDERAL COMMUNICATIONS COMMISSION
WASHINGTON, D.C. 20554

In the Matter of Price Cap Performance Review for Local Exchange Carriers	)	CC Docket No. 94-1

COMMENTS OF THE GENERAL SERVICES ADMINISTRATION

The General Services Administration ("GSA"), on behalf of the Federal Executive Agencies, hereby submits its Comments in response to the Commission's Notice of Proposed Rulemaking ("NPRM"), FCC 94-10, released February 16, 1994. This NPRM requested comments and replies on the Commission's price cap plan for local exchange carriers ("LECs").

I. INTRODUCTION

The Commission states that the basic purpose of this review of the LEC price cap plan is "to consider whether the plan should be revised to better serve the goals of the Communications Act and the public interest in the years ahead."[1]

[1] NPRM, p. 2.

GSA commends the Commission for initiating this proceeding early in the fourth year of the plan. Although GSA continues to support the goals and framework of the plan, GSA believes that certain revisions are absolutely necessary to ensure that ratepayers, as well as LECs, benefit from this alternative to traditional rate of return regulation.

The Commission seeks data, analysis and comment on the goals, rules and transitional mechanisms of the plan. In these Comments, GSA will propose revisions to the plan designed to restore the balance of ratepayer and carrier interests in the years ahead.

II. THE COMMISSION SHOULD REAFFIRM THAT THE PRIMARY GOAL OF THE PRICE CAP PLAN IS JUST AND REASONABLE RATES FOR INNOVATIVE, HIGH QUALITY SERVICES (GENERAL ISSUE 1).

In adopting the LEC price cap plan in 1990, the Commission stated its purpose as follows:

> In designing an incentive-based system of regulation for the largest LECs, our objective, as with our price caps system for AT&T, is to harness the profit-making incentives common to all businesses to produce a set of outcomes that advance the public interest goals of just, reasonable, and nondiscriminatory rates, as well as a communications system that offers innovative, high quality services.[2]

[2] Policy and Rules Concerning Rates for Dominant Carriers, CC Docket No. 87-313, Second Report and Order released October 31, 1990 ("Price Cap Order"), p. 3.

Although the Commission finds that these goals remain valid, it seeks comment on whether their refinement is warranted by changes in telecommunications technology and markets.[3]

Specifically, the Commission seeks comment on whether price cap regulation has not only benefitted consumers, but also whether it has benefitted the economy, creating net economic gains and jobs.[4] The Commission seeks comment on whether price cap regulation encourages the development of the national information infrastructure and needed telecommunications services for education, health care and emergency services.[5] Finally, the Commission seeks comment on whether price cap regulation promotes universal service, competition and open access to the network.[6]

GSA believes that the Commission should keep its price cap plan in perspective. While all of the goals mentioned may be valid ones for the Commission to pursue in one way or another, the price cap plan has as its primary purpose the assurance of <u>just and reasonable rates for innovative, high quality services</u>. GSA agrees with the Commission that the price cap plan can be a better regulatory tool than traditional rate of return regulation for achieving this primary goal, if the plan is properly administered. As GSA will demonstrate, however, current LEC access rates are <u>not</u>

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[3] NPRM, p. 13.

[4] <u>Id</u>.

[5] <u>Id</u>., p. 14.

[6] <u>Id</u>.

just and reasonable, and prompt action by the Commission is necessary to correct this situation.

Although GSA believes the Commission must affirm that the assurance of just and reasonable rates is the primary goal of the price cap plan, the attainment of this goal provides a firm foundation for the pursuit of the Commission's other goals. Just and reasonable rates achieved through increased LEC productivity will benefit the economy, create jobs and promote universal service. Such rates also allow infrastructure development, competition and open access to be implemented in an economically efficient manner to the ultimate benefit of all consumers.

In summary, the Commission should not revise the goals of the LEC price cap plan. Instead, it should revise the price cap plan to better meet its existing goals.

III. PRICE CAP INDICES SHOULD BE REDUCED TO REFLECT THE FALL IN THE COST OF CAPITAL (BASELINE ISSUE 3).

The Commission notes that interest levels "have fallen to their lowest levels in many years,"[7] and seeks comment on "whether a one-time change in the LEC's price cap index should be required."[8] GSA believes that a reduction in LEC price cap indices to reflect the fall in the cost of capital is absolutely essential to restore just and reasonable rates.

[7] Id., p. 19.

[8] Id., p. 20.

Concurrent with the adoption of the Price Cap Order, the Commission reduced the LEC authorized rate of return to 11.25 percent and required all LECs to retarget their rates effective January 1, 1991.[9] This rate of return remains in effect and underlies all price cap indices.

The cost of capital has fallen substantially since the Commission adopted its ROR Order in September, 1990. The yield on thirty-year Treasury Bonds, for example, fell from 9.03 percent to a low of 5.94 percent in October, 1993. On April 25, 1994 the yield was 7.26 percent, still <u>177 basis points</u> below September, 1990.[10] Similarly, the yield on ten-year treasury bonds fell from 8.89 percent to 5.33 percent in October, 1993. On April 25, 1994 the yield was 7.00 percent, still <u>189 basis points</u> below September, 1990.[11] The yield on S&P AA Public Utility Bonds fell from 10.11 percent to 7.34 percent in December, 1993. In February, 1994 the yield was 7.69 percent, fully <u>242 basis points</u> below September, 1990.

Under traditional rate of return regulation it is likely that LEC rates would have been retargeted long before now to a lower

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[9] Represcribing the Authorized Rate of Return for Interstate Services of Local Exchange Carriers, CC Docket No. 89-624, Order released December 7, 1990 ("ROR Order"), p. 1.

[10] USA Today, April 29, 1994, p. 3B.

[11] <u>Id</u>.

rate of return. In fact, GSA urged the Commission to conduct a rate of return represcription over a year and a half ago.[12]

In any case, the Commission should immediately commence a proceeding designed to result in a new rate of return to be effective on January 1, 1995. The Commission should base this proceeding on the long-awaited revision to its rules resulting from its ROR NPRM.

LEC access rates should not be retargeted to this new rate of return, however. In keeping with the incentive based nature of the price cap plan, the revenue requirement effect of the change in rate of return from 11.25 percent should be used to adjust LEC price cap indices on January 1, 1995. This procedure recognizes that a change in the cost of capital is analogous to an exogenous factor. Whenever the Commission changes the LEC authorized rate of return, the LEC price cap indices should be adjusted.

The Commission also seeks comments on whether it should adopt a mechanism which would adjust the plan to reflect changes in interest rates.[13] In its Comments to the ROR NPRM, GSA recommended just such a mechanism.[14] In summary, GSA recommended that the Commission examine the yield on ten-year Treasury Bonds for August of each year. If the yield is 150 basis points above or below the

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[12]Amendment of Part 65 and 69 of the Commission's Rules to Reform the Interstate Rate of Return Represcription and Enforcement Processes, CC Docket No. 92-113, Notice of Proposed Rulemaking released July 14, 1992 ("ROR NPRM"), Comments of GSA, September 11, 1992, p. 10.

[13]NPRM, p. 20.

[14]ROR NPRM, Comments of GSA, pp. 8-13.

yield at the time of the last prescription, the Commission should initiate a paper proceeding to determine the new rate of return to be effective with the next annual access tariff filing. This simple procedure will be responsive to changes in the capital markets and ensure that the underlying level of access rates remains just and reasonable.

As GSA demonstrated in its Comments to the ROR NPRM, although this trigger would have resulted in only six represcriptions in the twenty-four year period from 1967 to 1991, it would have resulted in a closer tracking of allowed rates of return to required rates of return.[15]

IV. THE SHARING AND LOW-END ADJUSTMENT MECHANISMS SHOULD BE REALIGNED WITH CAPITAL COSTS (BASELINE ISSUE 4).

The Commission requests comment on whether the sharing and low-end adjustment mechanisms should be realigned with capital costs.[16] GSA recommends that these mechanisms be adjusted whenever a new rate of return is prescribed. These mechanisms protect both ratepayers and stockholders from unusual circumstances that may impact a particular LEC participating in the price cap plan.

Much of the gain in productivity experienced by telecommunications companies is attributable to economic growth and the application of advanced technologies to meet the needs of particular markets. A given LEC's productivity in a given year may

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[15]ROR NPRM, Comments of GSA, p. 9.

[16]NPRM, p. 23.

deviate from expected levels for many reasons, including regional economic changes, which are quite beyond the LEC's control. The sharing mechanism ensures that ratepayers share in the results of unexpectedly high LEC productivity in a given year, while the lower adjustment mark gives some relief to stockholders in periods when productivity is below expectations.

Although the Commission did not specifically request comments on the 16.5 percent ceiling rate of return, GSA believes the necessity for this mechanism should be reconsidered. By requiring all earnings over any level to be returned to ratepayers, the Commission is giving carriers the perverse incentive to cease controlling costs once they reach this level. GSA does not believe this mechanism serves any useful purpose in an incentive regulation plan.

V. THE PRODUCTIVITY FACTOR SHOULD BE INCREASED (BASELINE ISSUE 3).

The Commission requests comment on whether the productivity factor used to compute LEC price cap indices should be changed.[17] GSA recommends that the factor be increased at this time and then re-evaluated during each future price cap review.

Conceptually, if a LEC's productivity has increased at the same rate as its chosen price cap productivity factor (either 3.3 percent or 4.3 percent), its earnings would be 11.25 percent in 1993, since this is the earnings level at which rates were set on January 1, 1991. Earnings above 11.25 percent in 1993 indicate

[17]NPRM, p. 20.

annual productivity greater than the existing factors; earnings below 11.25 percent indicate annual productivity less than the existing factors. On Attachments 1 to 3 of these Comments, GSA has displayed the price cap earnings of the Bell Operating Companies by Regional Holding Company ("RHC") from 1991 to 1993 as reported on the Rate of Return Monitoring Report, FCC Form 492. Composite RHC price cap earnings have been as follows:

1/1/91	11.25%
1991	11.81
1992	12.52
1993	13.38

Clearly, RHC productivity has exceeded the existing 3.3/4.3 percent factors over this period.

Attachment 4 quantifies the difference between the existing productivity factors and those which would have resulted in the maintenance of an 11.25 percent rate of return. The difference between the starting rate of return ("ROR") on Line 2 and the 1993 RHC ROR on Line 1 is 2.13 percent. When multiplied by the 1993 RHC rate base on Line 4, this difference equates to $526,342,000 as shown on Line 5. After the application of the tax gross-up factor on Line 6, the revenues in excess of a 11.25 percent ROR are shown as $830,094,000 on Line 7. When divided by total RHC 1993 revenues on Line 8, this amount is shown on Line 9 as 5.0 percent of total revenues. The compound annual growth rate which would result in this percent difference over three years is 1.6 percent as shown on Line 10. Adding this annual difference to the existing 3.3/4.3

productivity factors indicates that the original 11.25 percent ROR would have been maintained if the productivity factors had been originally set at 4.9/5.9 percent.

There are four possible reasons for this difference in realized productivity. First, the original productivity factors may have inadvertently been set below actual RHC historical productivity due to errors in estimation. Second, RHC productivity rates may have increased over their historical level. Third, the realized productivity over this initial period may not be representative of a sustainable level of RHC productivity. Finally, RHC rates may not actually have been targeted to achieve an 11.25 percent ROR effective January 1, 1991.

Rather than engage in protracted debate over the relative importance of each of these reasons, GSA proposes that the Commission merely recognize that the existing productivity rates are not adequate, and increase them. GSA recommends that the Commission establish a procedure under which the productivity factor is adjusted by half of the difference between expected and realized productivity at the time of each price cap review. In this case, for example, the application of this procedure would result in new productivity factors of 4.1 and 5.1 percent. This procedure would enable both ratepayers and stock holders to share in the benefits of LEC productivity. It would also help ensure that LEC rates remain just and reasonable over time.

VI. THE COMMISSION SHOULD MEASURE THE GROWTH OF COMPETITION IN THE LOCAL EXCHANGE AND INTERSTATE ACCESS MARKETS (TRANSITION ISSUE I).

The Commission requests comment on the current state of competition for local exchange and interstate access, and the criteria which should be used for determining when reduced or streamlined regulations for price cap LECs should take effect.[18]

GSA commends the Commission for beginning the process of collecting information on the state of competition for local exchange and interstate access. Indeed, GSA believes that as competition increases, reduced or streamlined regulations will be appropriate for price cap LECs. As AT&T's market power diminished in the interexchange market, for example, the Commission gradually reduced its pricing regulations on AT&T. By 1989, AT&T's share of interstate switched minutes had fallen below 70 percent, and its price cap plan was initiated without a sharing provision.[19] Since then, AT&T's market share has fallen to about 60%, and the Commission has removed AT&T's business and 800 service from price cap regulation.[20] A measured approach such as this would certainly be appropriate in regulating the LECs as competition increases for local exchange and interstate access.

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[18]NPRM, p. 40.

[19]Long Distance Market Shares, FCC, April 1994, p. 9.

[20]Id.

Nearly a year ago, GSA proposed that the Commission establish a plan to monitor local exchange competition.[21] GSA now recommends that the Commission use the information generated by this NPRM to establish a formal reporting program which will allow it to measure the growth of competition for local exchange and interstate access over time.

The Commission should monitor not only the potential for effective competition, but also its realization, on a state by state basis. The Commission should establish periodic reports on the existence of regulatory barriers to market entry, the existence of competitors, the extent to which competitors have the facilities to serve LEC customers, and the market share actually captured by LEC competitors.

The Commission will have to require data from all competitive access providers ("CAPs") handling interstate calls, as well as all LECs, for its monitoring program to be effective. This reporting requirement need not be burdensome, however. For example, reports would include facilities information such as that currently summarized on the Commission's Fiber Deployment Update.[22] Reports would also include revenue and traffic data such as that currently summarized on the Commission's report on Long Distance Market

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[21]Ameritech's Petition for Declaratory Ruling and Related Waivers to Establish a New Regulatory Model for the Ameritech Region, Public Notice, DA 93-481, released April 27, 1993, Reply Comments of GSA, July 12, 1993, pp. 22-23.

[22]See, e.g., Fiber Deployment Update - End of Year 1992, Industry Analysis Division, April 1993.

Shares.[23] GSA recommends that the Commission require all CAPs and LECs to report their basic data on a biannual basis for Commission publication.

GSA supports full and open competition in all aspects of telecommunications. The establishment of a formal monitoring program by the Commission will not only provide the basis for prudent revision of the LEC price cap plan, it will also provide a reliable information resource for all those engaged in the national debate over the future of telecommunications in America.

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[23] *See, e.g.*, *Long Distance Market Shares: Fourth Quarter, 1993*, Industry Analysis Division, April 1994.

VII. CONCLUSION

As the agency vested with the responsibility for acquiring telecommunications services for use of the Federal Executive Agencies, GSA urges the Commission to reaffirm that the primary goal of the price cap plan is just and reasonable rates for innovative, high quality services; to immediately commence a proceeding designed to result in a new rate of return to be effective January 1, 1995; to adjust LEC price cap indices and sharing and low-end adjustment mechanisms to reflect this new rate of return; to increase the productivity factors to 4.1 and 5.1 percent; and to establish a formal program to monitor local exchange and interstate access competition.

Respectfully submitted,

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May 9, 1994

Attachment 1

BELL OPERATING COMPANY EARNINGS

BY

REGIONAL HOLDING COMPANY

($000)

1991

REGIONAL HOLDING COMPANY	Total Revenues	Operating Income	Rate Base	Rate of Return
AMERITECH	$2,041,409	$381,424	$2,934,595	13.00%
BELL ATLANTIC	2,580,220	512,222	3,993,150	12.83%
BELLSOUTH	2,847,054	587,163	4,651,707	12.62%
NYNEX	2,966,286	395,024	4,223,468	9.35%
PACIFIC TELESIS	1,543,188	293,012	2,464,671	11.89%
SOUTHWESTERN BELL	1,679,976	342,754	3,187,837	10.75%
U.S. WEST	2,096,115	452,238	3,645,651	12.40%
RHC TOTAL	$15,754,248	$2,963,837	$25,101,079	11.81%

Source: FCC 492 Reports

Attachment 2

BELL OPERATING COMPANY EARNINGS

BY

REGIONAL HOLDING COMPANY

($000)

1992

REGIONAL HOLDING COMPANY	Total Revenues	Operating Income	Rate Base	Rate of Return
AMERITECH	$2,096,755	$384,393	$3,005,755	12.79%
BELL ATLANTIC	2,632,898	503,328	4,025,434	12.50%
BELLSOUTH	2,906,345	593,857	4,640,349	12.80%
NYNEX	2,995,195	493,561	3,947,104	12.50%
PACIFIC TELESIS	1,556,030	315,215	2,475,286	12.73%
SOUTHWESTERN BELL	1,737,426	363,490	3,079,951	11.80%
U.S. WEST	2,118,868	449,283	3,620,579	12.41%
RHC TOTAL	$16,043,517	$3,103,127	$24,794,458	12.52%

Source: FCC 492 Reports

BELL OPERATING COMPANY EARNINGS

BY

REGIONAL HOLDING COMPANY

($000)

1993

REGIONAL HOLDING COMPANY	Total Revenues	Operating Income	Rate Base	Rate of Return
AMERITECH	$2,169,383	$443,784	$2,998,024	14.80%
BELL ATLANTIC	2,724,780	558,428	4,019,372	13.89%
BELLSOUTH	3,007,176	634,779	4,625,662	13.72%
NYNEX	3,009,356	481,240	3,839,820	12.53%
PACIFIC TELESIS	1,626,885	332,995	2,533,580	13.14%
SOUTHWESTERN BELL	1,879,204	400,927	3,130,948	12.81%
U.S. WEST	2,198,180	454,319	3,563,495	12.75%
RHC TOTAL	$16,614,964	$3,306,472	$24,710,901	13.38%

Source: FCC 492 Reports

ATTACHMENT 4

RHC REVENUE GROWTH RATE
IN EXCESS OF EXISTING
PRODUCTIVITY FACTOR

($000)

1.	ACTUAL 1993 RHC ROR (ATTACH. 3)	13.38%
2.	ORIGINAL RHC ROR	11.25%
3.	CHANGE IN ROR (L1 - L2)	2.13%
4.	1993 RATE BASE (ATTACH. 3)	$24,710,901
5.	EARNINGS OVER 11.25% (L3 x L4)	$526,342
6.	TAX GROSS-UP FACTOR (1993 SOUTHWESTERN BELL TELEPHONE FCC FORM 492)	.5771
7.	REVENUE OVER 11.25% (L5 + L5 x L6)	$830,094
8.	1993 TOTAL REVENUES (ATTACH. 3)	$16,614,964
9.	PERCENT REVENUE OVER 11.25% (L7 / L8)	5.0%
10.	COMPOUND ANNUAL GROWTH RATE OVER 3 YEARS	1.6%

CERTIFICATE OF SERVICE

I, Tenley A. Carp, do hereby certify that copies of the foregoing "Comments of the General Services Administration" were served this 9th day of May, 1994, by hand delivery or postage paid to the following parties:

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